

Japan Tax Bulletin

2009 Tax Reform Measures To Promote Private Equity Investment in Japan By Foreign Funds



During the past several years, Japan has been attempting to encourage individuals and corporations (both Japanese and foreign) to invest in Japanese companies through private investment partnerships. The intention of the Japanese Government has been to encourage private equity as an additional source of funding for both start-up enterprises as well as distressed companies, as these types of entities have often found it difficult to access the more conventional bank financing or public securities markets.

For foreign investors, one of the problems has been the potential tax risks from investing into Japan through partnerships, due to the lack of clear and comprehensive tax rules particularly pertaining to foreign investors. Consequently, for example, in 2008, Japan adopted an independent agent exception, under which foreign investors can avoid a local tax nexus (permanent establishment or "PE") notwithstanding activities conducted on their behalf in Japan by an independent, on-shore fund manager under certain conditions.

The most recent round of changes again is directed squarely at foreign investors in certain collective investment vehicles. In early 2008, the Ministry of Economy, Trade and Industry ("METI") created a study group to investigate the historically low level of foreign direct investment ("FDI") through investment funds and to provide recommendations for increasing such FDI. Based on these efforts, METI proposed two measures which were designed to encourage foreign investment by reducing the potential Japanese tax burden on foreigners investing in private equity funds.

Specifically, the first provides an exemption from PE treatment for foreign limited partners in certain kinds of Japanese limited partnerships (or "similar" foreign partnerships). The second provides an exception for such partners from the partnership attribution that otherwise would combine their individual partnership interests with those of the other partners to determine whether the partner is subject to Japanese tax on capital gains from the sale of shares of a Japanese company due to holding a "substantial participation" (25% or more) in the company. The proposals, embodied in statutory amendments and related cabinet orders, were successfully incorporated into the 2009 tax reform, which was passed by the House of Representatives of the Diet on February 27, 2009 and became effective beginning April 1, 2009.

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Nevertheless, a close examination of the new rules has revealed a number of limitations and potential pitfalls of which foreign investors should be aware. While certain issues can be resolved through careful planning, some may be resolved through additional guidance to be published following the implementation of these measures, and others likely will require further dialogue with the pertinent Japanese authorities to clarify the interpretation and application of those rules.

PE Exemption for Limited Partners.

Background. Since the establishment of the first venture capital partnerships in Japan in the mid-1980's, a recurring tax issue for foreign investors has been whether a foreign partner investing in such a partnership would be considered to have a PE in Japan merely due to such investment, thereby becoming subject to ordinary Japanese individual income tax or corporation tax applicable to residents in respect of profits earned through such partnerships. The earliest such partnerships were simple Japanese partnerships (*nin'i kumiai*) under the Civil Code (*Minpo*) that were called "investment business partnerships" (*toshi jigyo kumiai*). At that time, the tax issue was whether such partnerships were engaged in business activities (*jigyo*) or were merely engaged in investing activities. If the "executive partner" (the partner charged with operating the partnership activities, in the same manner as a general partner) was engaged in business activities, a PE would arise. However, if the executive partner was simply identifying and investing in shares but not, for example, regularly buying and selling shares, providing consulting services for a fee, or performing other recurring activities, it was questionable whether it should be considered to be engaged in a business activity, as opposed to a mere investment activity.

Nevertheless, over the years, the activities of executive partners became broader, encompassing more active involvement in managing or advising invested companies, as well as providing different types of financing (such as loans) requiring more oversight. This resulted in an increased risk of PE treatment. Because the ultimate determination of whether the executive partner was engaged in a business or not would be made only after the fact during a tax audit, this risk was viewed as excessively high by most foreign investors. Consequently, various alternative offshore investment structures were created to reduce this risk for foreign investors by avoiding direct investments as partners in Japanese investment partnerships.

In 1998, however, METI sponsored an entirely new law designed to introduce a "limited liability partnership" investment vehicle in Japan. As noted above, the

previous venture capital funds had been simple Civil Code partnerships, which are a simple form of general partnership with no limited liability for investors. The Act Concerning Investment Business Limited Liability Partnership Agreements (Act No. 90 of 1998, as amended) (the "LPS Act") created an entirely new partnership, the "investment business limited liability partnership" (*toshi jigyo yugen sekinin kumiai*) ("Investment LPS"). An Investment LPS can have more than one general partner ("GP"), which partner(s) has the sole responsibility for managing the operations of the Investment LPS. The Investment LPS initially was subject to onerous restrictions in regard to both its investors and its permissible investments and, as a result, was not popular with the investing community. Subsequent amendments in 2004 substantially reduced the restrictions on the investors and broadened the scope of permissible investments.

Notwithstanding the 2004 amendments, the PE issue has continued to exist for foreign limited partners in an Investment LPS. Indeed, an Investment LPS was permitted to engage not only in investing in stock, but also providing loans, as well as rendering management advice or technical guidance to entities in which it invested, and its activities were routinely described as an "investment business." Consequently, the PE risk was substantial, if not certain in most cases.

However, under the METI proposal, a foreign limited partner, which is a non-resident individual or a foreign corporation and which has concluded an "investment partnership agreement," ("FLP") will not be deemed to have a PE in Japan ("PE Exemption"), notwithstanding that it otherwise is considered to have a PE in Japan concerning its business activities conducted pursuant to the investment partnership agreement. For this purpose, an "investment partnership agreement" is limited to: (a) an Investment LPS agreement; and (b) a foreign partnership agreement which is "similar" to an Investment LPS agreement as prescribed under the LPS Act. However, this treatment is available only if certain strict criteria are met and certain procedures are followed.

Requirements to Qualify for PE Exemption.

To qualify for the PE Exemption, all of the following must be satisfied:

- FLP does not in fact engage, directly or by attribution through another partnership, in the performance of the business carried on pursuant to the Investment LPS agreement;

- FLP owns, directly or by attribution through a “specified relationship,” an interest of less than 25% in the assets of the Investment LPS;
- FLP does not have a “specified relationship” with any GP of the Investment LPS;
- FLP does not otherwise already have an existing PE in Japan; and
- Certain reporting requirements are met.

Engaging in the Investment LPS Business.

The cabinet order provides that any of the following activities constitute the performance of the business carried on pursuant to the Investment LPS agreement (“Engaged in the Investment LPS Business”):

- Carrying out the business of the Investment LPS;
- Making decisions with respect to carrying out such business;
- Providing approval or consent with regard to such decisions; or
- Activities similar to the above.

In addition, the cabinet order appears to provide that, if an FLP is a partner in another partnership which itself conducts any of the above activities, then the FLP itself is deemed to conduct such activities.

Specified Relationship.

The cabinet order provides that, in determining whether an FLP owns less than 25% of the assets of the Investment LPS formed under an Investment LPS agreement, the interests in the Investment LPS assets of the following other partners with a “Specified Relationship” to the FLP are attributed to the FLP:

- **Related Individual.** A relative within six degrees of relationship (three degrees by marriage), a common law spouse, an employee of an individual FLP, other individuals economically supported by the FLP, a relative (within six degrees of relationship (three degrees by marriage)) of any of the foregoing individuals who live together with any such foregoing individual; or with respect to a corporate FLP, any director and any of the foregoing with respect to such director (for example, relatives of the director) (“Related Individual”).
- **Controlled Company.** Any company which the FLP and any Related Individuals: hold, directly or indirectly, >50% of the total amount of shares or voting rights; or comprise >50% of the shareholders/members of such company (“Controlled Company”).

- **Other Partnership(s).** Any partnership, other than the Investment LPS, which the FLP is a partner (“Other Partnership”). Any Investment LPS interests of other partners in the Other Partnership, which are not held through the Other Partnership, are not counted for this attribution purpose.

The interest in the “assets” of the Investment LPS is determined based on the higher of the total interest in the Investment LPS assets, or total of the profit allocation ratios, of the FLP and other partners with whom the FLP has a Specified Relationship.

In addition, the cabinet order provides that an FLP has a “specified relationship” with the GP if the GP is either a Related Individual or Controlled Company.

Investment LPS and “Similar” Foreign Investment LPS.

It is important to note that the PE Exemption applies only to Investment LPS agreements or “similar” foreign partnership agreements.” The statute does not specify the circumstances under which a foreign investment partnership agreement will be considered to be “similar” to an Investment LPS agreement (“Similar Foreign LPS Agreement”). Consequently, a thorough understanding of the Investment LPS under the LPS Act is necessary in order to determine if a particular foreign limited partnership, for example, will qualify as a Similar Foreign LPS Agreement.

Limitations on Activities of Investment LPS.

Significantly, the LPS Act limits the activities of an Investment LPS to the following:

Investment Assets. Acquisition and holding of:

- Stocks, stock warrants, other equity interests, bonds, and other securities issued by Japanese corporations (*kabushiki kaisha*) and certain other corporate entities;
- Equity interests in limited liability companies (*goudou kaisha*);
- Certain cash receivables of (issued by), or owned by, a Japanese entity or individual;
- New loans to a Japanese entity or individual;
- Equity investment through a silent partnership (*tokumei kumiai*) contract (TK Investment) in which a Japanese entity or individual acts as the operator (*eigyosha*);
- Beneficial interests in a trust in which a Japanese entity or person serves as the trustee; and
- Industrial (intellectual) property rights or copyrights (including granting a license to use the rights

relating thereto) owned by a Japanese entity or individual.

Management Consulting Services. Provision of management-related advice and technical guidance to a Japanese entity or individual in relation to which the Investment LPS owns any of the Investment Assets listed above.

Investment in an Investment LPS, Etc. Investment in an Investment LPS, a Japanese partnership (*kumiai*) the purpose of which is to pursue an investment business, or similar organizations located in a foreign country.

Ancillary Business Activities. The cabinet order prescribes the following additional business activities:

- Acquisition and holding of certain promissory notes issued or owned by a Japanese entity or individual, as well as negotiable certificates of deposit; and
- Purchase, sale, exchange or lease, or brokering or mediation of real estate or movable property which secures promissory notes or cash receivables acquired by the Investment LPS with respect to the above.

Foreign Securities. Acquisition and holding of stock, stock warrants, other equity interests, bonds, and other securities issued by foreign corporations; provided that such investment does not hinder the above business and such foreign holdings are limited to 50% of the total capital contribution of the partners.

Investment of Surplus Cash. Surplus cash may be invested in deposit accounts; postal savings; Japanese government or municipal bonds; or bonds issued or guaranteed by: (i) a foreign or local government, (ii) an international institution, (iii) a foreign government affiliated institution (that is, an institution in which the main equity investor is a foreign local government in which the head or principle office of the institution is located), (iv) a corporation in which a local government is the main equity investor, or (v) a foreign bank or other financial institution.

It is important to note that the Investment LPS is not permitted to own certain assets such as real property, except with respect to real property (and neighboring property) secured by promissory notes or cash receivables acquired by the Investment LPS as noted above, and common units in a Special Purpose Company (*Tokutei Mokuteki Kaisha*) which is used for the liquidation of distressed real estate or other business assets.

Limitation on Interests in Investment LPS.

Under the LPS Act, each partner of an Investment LPS must own at least one unit of investment. The cash value of one unit of investment must be uniform. A partner's investment may be made only in the form of cash or other assets. Thus, a partner is generally not permitted to make an investment in the form of services (unlike the case with *nin'i kumiai*, for example).

Reporting Requirements.

To obtain the PE Exemption, a FLP must apply by filing certain forms through the GP of the Investment LPS, which forms include information which demonstrates that the FLP satisfies all the requirements for the PE Exemption. The law also requires that a FLP report all Japanese source income which would be included in the computation of the taxable income of a Japanese tax resident, but which income is not so treated (as taxable income) because of the PE Exemption.

Based on this, it is not clear from the statute or cabinet order whether the FLPs must also report all other Japanese source income, whether or not related to the Investment LPS. If the PE Exemption did not apply and thus, the FLP is treated as having a PE in Japan, then any other Japanese source income (whether or not related to the Investment LPS) would be subject to tax as the income of a Japanese tax resident under Japanese domestic tax law. However, if the PE Exemption applies, then such other Japanese source income would not generally be subject to tax as the income of a Japanese tax resident. Thus, read literally, it appears that the statute would require that a FLP report all other Japanese source income because such income would not be subject to tax as the income of a Japanese tax resident.

Exception from Partnership Attribution Rule

Except with respect to certain holdings in a Japanese real property holding company, Japan does not generally impose tax on capital gains from the sale or other disposition of shares of a Japanese company by a non-resident individual or foreign corporation, unless: (a) the foreign shareholder owns directly or through attribution 25% or more of the outstanding shares of the Japanese company; and (b) that foreign shareholder disposes of 5% or more of such shares, taking into account any shares disposed of by related parties, in the same tax year. This is referred to as the "25/5 Rule," which is a kind of substantial participation rule. Consequently, as long as the foreign investor owns less than 25%, then any gains from the disposition of such shares would avoid taxation in Japan.

In determining whether either the 25% ownership or 5% disposition of outstanding shares threshold is met, a rule was adopted in 2005 which attributes all shares held by the partnership of the foreign partner ("Partnership Attribution Rule"). This significantly increased the potential for foreign partners to be subject to Japanese tax, especially in the private equity context, where such funds often take substantial or majority ownership stakes in the companies in which they invest. However, under the second of METI's proposals, the cabinet order creates an exception from the Partnership Attribution Rule for FLPs in Investment LPS or "similar" foreign Investment LPS, which would generally result in the FLP being deemed to own shares in the Japanese company equal only to the FLP's interest in the Investment LPS or "similar" foreign Investment LPS ("Partnership Attribution Exception"). That is, the FLP is not deemed to own all the shares held by the Investment LPS or similar foreign Investment LPS. The Partnership Attribution Exception is subject to the following additional requirements and limitations:

- **Minimum Period as an FLP.** The FLP must have been an FLP of the Investment LPS (or similar foreign Investment LPS) for the lesser of: (i) the period starting from the second fiscal year prior to the year in which the disposition occurs until the end of the year in which the disposition occurs; or (ii) the period in which the FLP was an FLP of the Investment LPS prior to the disposition until the end of the year in which the disposition occurs;
- **Not Engaged in the Investment LPS Business.** The FLP, directly or by attribution, must not have been Engaged in the Investment LPS Business for the lesser of: (i) the period starting from the second fiscal year prior to the year in which the disposition occurs, until the end of the year in which the disposition occurs; or (ii) the period in which the FLP was an FLP of the Investment LPS prior to the disposition until the end of the year in which the disposition occurs;
- **Less Than 25% Interest in Investment LPS.** FLP cannot have owned, directly or by attribution through a Specified Relationship, 25% or more of the Investment LPS assets (based on the higher of the total of the assets or profit allocation ratios) at any time within the period starting from the second fiscal year prior to the year in which the disposition occurs until the end of the year in which the disposition occurs;
- **Holding Period for Shares Disposed Of.** The Japanese company shares disposed of must have been held by the Investment LPS for at least one year; and

- **Certain Distressed Financial Institutions.** The shares disposed of cannot include shares of a "distressed financial institution" (a "special crisis management bank" (*Tokubetsu Kiki Kanri Ginkou*) as defined in the Deposit Insurance Law (*Yokin Hoken Hou*)).

It is important to note that the Partnership Attribution Rule itself was not repealed and, as a result, except with respect to partners of an Investment LPS or similar foreign partnership, it continues to apply to attribute ownership from any other partners for purposes of computing the 25% ownership and 5% disposition of outstanding shares thresholds under the 25/5 Rule.

Combined Impact of PE Exemption and Partnership Attribution Exception

The combined effect of the PE Exemption and the Partnership Attribution Exception potentially will be to enable foreign investors in certain private equity and other investment funds to avoid or significantly reduce Japanese tax on their allocable share of certain income and capital gains from the disposition of the fund's investments. This is because: (i) under the PE Exemption, each FLP would not be deemed to have a PE in Japan, even though the fund, through the GP, itself were to be considered as conducting business activities in Japan; and (ii) under the Partnership Attribution Exception, the likelihood that each LP would be able to avoid being subject to the 25/5 Rule (and thus, be exempt from Japanese tax on capital gains on dispositions of shares) would be increased because all shares held by the Investment LPS (or similar foreign Investment LPS) would not be attributed to the FLP in determining the 25% ownership and 5% disposal of outstanding shares thresholds.

Generally, a non-resident individual investor in Japanese equities or non-performing loans ("NPLs") is subject to the Japanese income tax applicable to Japanese tax residents. Thus, dividends are taxed at up to 50%, the highest marginal rate (10% for listed shares), capital gains from the sale or disposition of such equity investments is taxed at 20% (10% for listed shares sold through a Japanese registered securities broker) and up to 50% in the case of NPLs, and collection gain from NPLs is taxed at up to 50%. In the case of a foreign corporate fund investor, dividends are taxed at up to 21%, the highest marginal rate after taking into account a 50% dividends received deduction (0% if the investor owns 25% or more of the shares), capital gains from the sale or disposition of such equity investments or NPLs, and collection gain from NPLs is taxed at up to 42%. However, by avoiding a PE, these rates may be substantially lower in the following cases:

- **Dividends.** If an investor is not deemed to have a PE in Japan, then the individual or corporate investor is subject only to a 20% withholding tax on dividends (reduced to 7% for listed shares);
- **Capital Gains.** If the investor is not deemed to have a PE in Japan, then on a sale of shares, the investor is generally subject to a tax of 15% and 30% for individuals and corporations, respectively. However, there is no capital gains tax on dispositions of NPLs.
- **Collection Gain from NPLs.** If the investor is not deemed to have a PE in Japan, then the investor is generally subject to a tax of up to 40% and 30% for individuals and corporations, respectively; or
- **Preferential Treaty Treatment.** Under an applicable tax treaty between Japan and the investor's resident jurisdiction, the determination as to what activities constitute a PE are determined under the treaty, and the Japanese tax on dividends, capital gains, and collection gain may be further reduced. However, the newer Japanese treaties often require that each fund investor file (and regularly update) a form to apply for treaty benefits. Thus, as a practical matter, many funds and investors elect not to claim applicable treaty benefits.

The following table summarizes the taxation (using the highest marginal rates) of foreign fund investors investing in Japanese equities.

| INVESTOR: | HAS A PE | DOES NOT HAVE A PE |
|-----------------------|---|--|
| - INDIVIDUAL | | |
| Dividends | 50% (10% for listed shares) | 20% (7% for listed shares)* |
| Capital Gain - Shares | 20% (10% for listed shares sold through a Japanese securities broker) | 15% (0%, if <25% of shares held, or <5% of shares sold during the tax year)* |
| Capital Gain - NPLs | 50% | 0% |
| NPL Collection Gain | 50% | 40%* |
| - CORPORATION | | |
| Dividends | 21% (0% , if ≥25% of shares held)* | 20% (7% for listed shares)* |
| Capital Gain - Shares | 42% | 30% (0%, if <25% of shares held, or <5% of shares sold during the tax year)* |
| Capital Gain - NPLs | 42% | 0% |
| NPL Collection Gain | 42%* | 30%* |

* Under an applicable income tax treaty, the determination as to what activities constitute a PE are generally specified and limited, and the Japanese tax on dividends and capital gains may be reduced.

Based on the above, Japanese taxation of foreign private equity fund investors can be significantly minimized if the investor is not deemed to have a PE and, in the case of capital gains on the disposition of shares in a Japanese company by increasing the chances of avoiding tax under the 25/5 Rule.

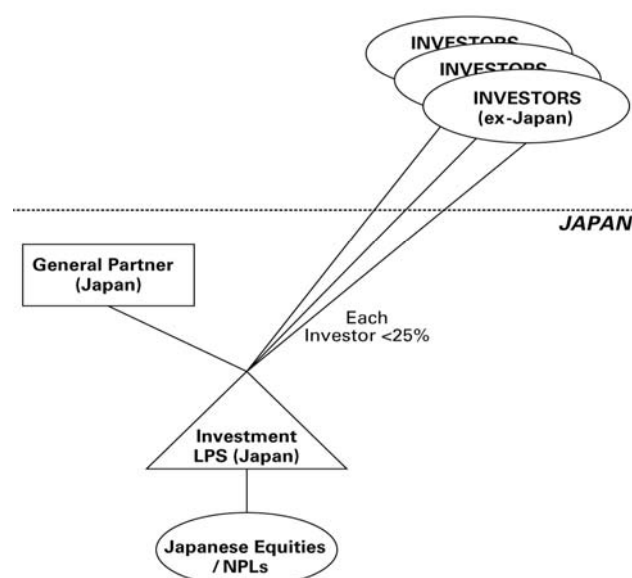
Practical Issues for Foreign Investment Funds.

The statute and accompanying cabinet order, which was publicly released on March 31, 2009 do not address a number of important issues, clarification of which will be necessary to ensure that the measures actually provide the benefits intended. The most important of these involve whether the structure of foreign private equity funds' investments into Japan will satisfy the requirements to benefit from these measures and whether the reporting requirements will not, as a practical matter, be so burdensome on funds and their investors that they decide not to invest in Japan.

Application to a "Similar" Foreign Investment LPS.

The requirement for using an Investment LPS vehicle should clearly be satisfied where the fund vehicle is in fact a domestic Investment LPS. See Figure 1, *Simple Investment LPS Structure*. However, where a foreign investment fund is set up using a foreign fund vehicle (e.g., foreign limited partnership), it is unclear what criteria will be used to determine whether the foreign limited partnership agreement is "similar" to an Investment LPS agreement. See Figure 2, *Offshore Investment LPS Structure*.

FIGURE 1: SIMPLE INVESTMENT LPS STRUCTURE



As discussed above, an Investment LPS is a unique vehicle designed specifically for investment in Japanese equities and other securities. Thus, it is unclear whether a foreign vehicle, the activities of which are not limited to those enumerated in *Limitations on Activities of Investment LPS* above will qualify. In addition, it is unclear whether the vehicle must be in the form of a limited partnership (with at least one partner having unlimited liability and one partner having limited liability), have uniform cash value of its partnership interests, require have only cash or assets can be contributed for partnership interests (no interests in exchange for services), etc.

The restriction on partnership interests received for services rendered raises a question regarding whether a typical investment fund partnership agreement containing a carried interest for the GP (fund manager) would be treated as “similar” to an Investment LPS agreement. From a technical standpoint, the concept of “carried interest” does not exist in Japan; rather, the economic objectives of a “carried interest” have customarily been met through the use of so-called “success fees” (*seikou houshu*) payable to certain partners as compensation for services rendered. It is unclear whether the economic substance of a “success fee” and “carried interest” would be considered sufficiently “similar.”

Application to Tiered Fund Structures.

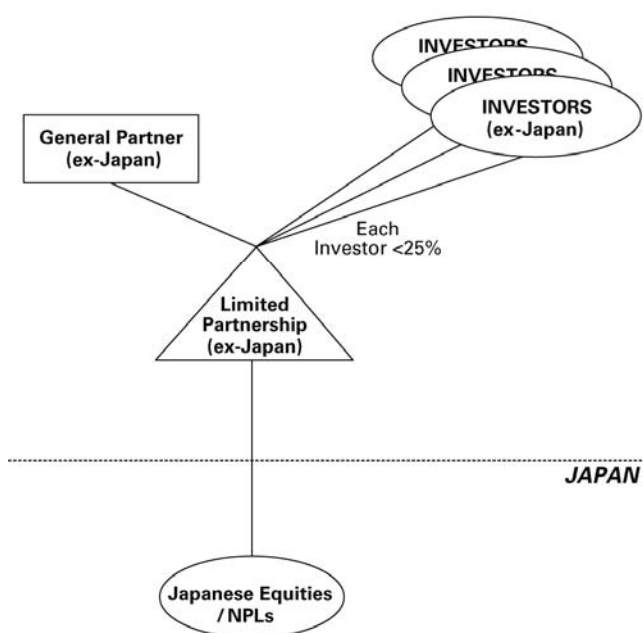
One of the more important issues is whether the PE Exemption will apply in the case of a multi-tiered fund structure. Rather than having a single fund vehicle, it is common for a foreign fund to utilize one or more subsidiary vehicles for individual investments, or for so-called feeder funds to invest in other funds. Thus, to benefit from the PE Exemption, a typical foreign fund structure might consist of an offshore fund vehicle, such as a foreign limited partnership, investing into an on-shore Investment LPS. See *Figure 3, Offshore LP Fund Structure*. In this example, the fund’s general partner entity would similarly set up a subsidiary on-shore entity to serve as the GP of the Investment LPS. Unlike non-Investment LPS partnerships, TK (*tokumei kumiai*) arrangements, and other structures in which the risk of creating a PE increases the potential cost to investors, the benefit of such a multi-tiered Investment LPS structure would potentially be to allow the fund’s managers to conduct investment activities in Japan without creating a PE for (and thus, higher Japanese tax on) its investors.

However, whether such a structure would qualify for the PE Exemption and thus, increase FDI into Japan will depend on the resolution of certain issues including: Whether the upper-tier foreign fund vehicles are treated either as Investment LPS or as transparent entities for Japanese tax purposes; Whether, under the attribution rules, interests in the onshore Investment LPS are attributed to each foreign fund investor; Whether, because of the partnership relationship between fund investors and the GP, the foreign fund investors will be treated as having a “specified relationship” with the GP of the subsidiary Investment LPS or as having control over its management; and Whether the reporting requirements for the foreign fund investors are acceptable.

If the foreign fund’s limited partnership agreement itself can qualify as “similar” to an Investment LPS agreement, then presumably the foreign fund investors would be eligible for the PE Exemption with respect to the foreign fund’s ownership interest in the on-shore Investment LPS. Under the Investment LPS law, investing in another Investment LPS is permitted. However, as discussed in the *Application to a “Similar” Foreign Investment LPS* above, it is unclear whether the foreign fund’s limited partnership agreement would be treated as “similar” to an Investment LPS.

If the foreign fund’s limited partnership agreement cannot qualify as “similar” to that of an Investment LPS, then unless the upper-tier foreign fund is treated as a transparent entity for Japanese tax purposes, the individual investors will not be able to benefit from the PE Exemption. This is because, under the statute, the PE Exemption applies only to an FLP. Because the foreign fund investors of the upper-tier Fund limited

FIGURE 2: OFFSHORE INVESTMENT LPS STRUCTURE



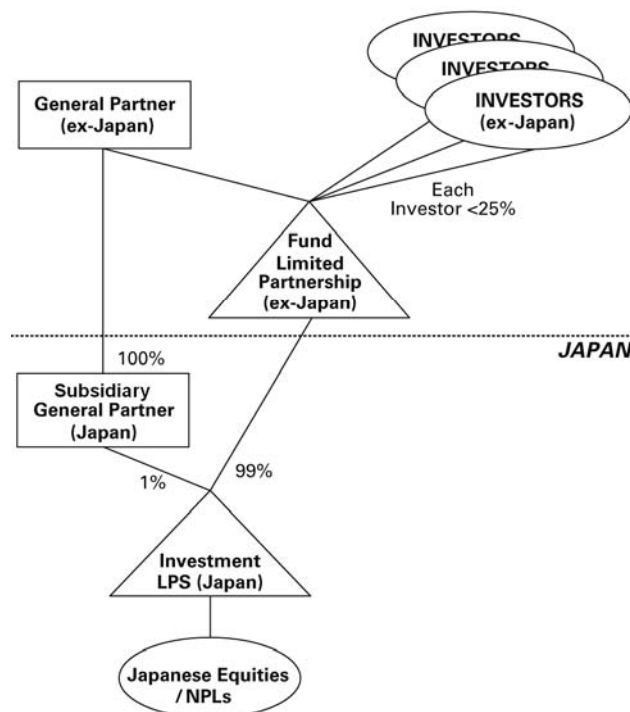
partnership are not technically the FLP in the onshore, lower-tier Investment LPS, such investors would not technically qualify for the PE Exemption. Moreover, because the foreign fund vehicle, which in Figure 3 owns a 99% interest in the Investment LPS, is legally the FLP in the onshore Investment LPS, the less than 25% interest in the assets of the Investment LPS requirement cannot be met unless the individual foreign investors, which in the example each hold a <25% interest, are instead treated as the FLPs. Generally, if the form of the upper-tier foreign fund is a limited partnership which is generally treated as a partnership (*kumiai*) for Japanese tax purposes, the foreign fund should be treated as a transparent entity and thus, individual investors will each be deemed to be a FLP in the Investment LPS.

However, under the attribution rules of the cabinet order, an FLP is deemed to own all the shares of any Other Partnership in which the FLP is a partner. If the upper-tier foreign fund is treated as an Other Partnership, then each investor in the foreign fund will be deemed to own all of the fund's 99% interest in the Investment LPS and thus, would fail the <25% ownership in the Investment LPS assets requirement. As it is not clear how the attribution rules should be applied in an upper-tier fund structure, further guidance from the Japanese tax authorities will be needed to assure foreign investors that the PE Exemption can apply in a tiered fund structure.

In addition to the <25% interest requirement, the foreign fund investors must not be involved in the management of the onshore Investment LPS or have a specified relationship with the GP of the onshore Investment LPS. Where the investors are partners in the foreign fund limited partnership with the general partner which itself owns the GP, it is unclear whether the investors would be deemed to either be involved in the management of the onshore Investment LPS or have a specified relationship with the GP, due to their relationship as partners in the foreign fund limited partnership.

Another issue is whether it is possible to obtain the necessary disclosure forms from the foreign fund investors, as is required to obtain the PE Exemption. As a practical matter, for many investment funds, obtaining signed forms (which may need to be updated from time to time) from investors is not possible. However, there may be situations in which certain funds obtain forms from investors, such as where investors wish to claim reduced Japanese withholding tax or other benefits under an applicable tax treaty, which requires them to file Japanese tax treaty application forms. In such cases, adding the PE Exemption form would probably not cause a significant, additional burden on the fund or its investors.

FIGURE 3: OFFSHORE LP FUND STRUCTURE



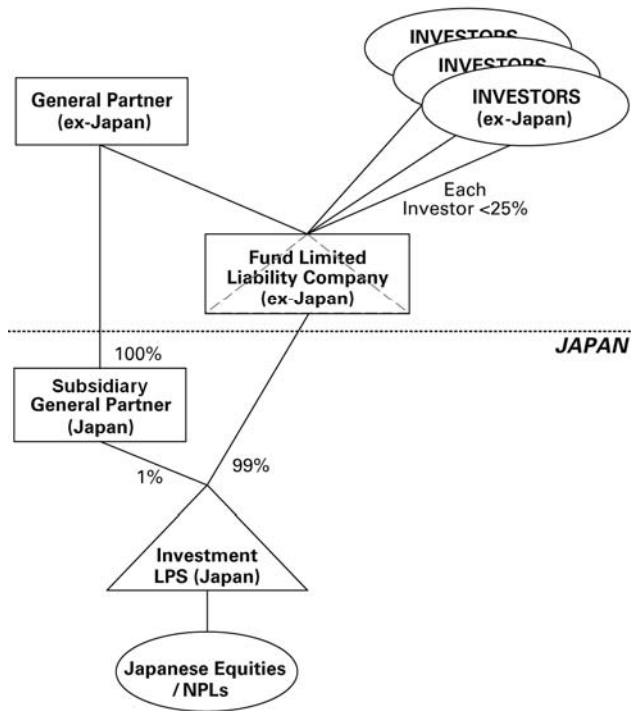
Foreign Funds Structured as LLCs.

Foreign investors in foreign funds structured as limited liability companies (“LLCs”), rather than as limited partnerships, will probably not be able to qualify for the PE Exemption. For Japanese tax purposes, an LLC is generally treated as a corporation (*houjin*), a separate taxable entity, rather than as a tax-transparent (pass-through) entity, such as a partnership (*kumiai*). Based on this treatment, the individual LLC fund investors would not be treated as the investors in the Investment LPS; rather the LLC fund itself would be treated as the investor in the Investment LPS. See Figure 4, *Offshore LLC Fund Structure*.

If an LLC fund holds a 99% interest in the Investment LPS and is treated as the investor in the Investment LPS, then it would not meet the less than 25% ownership in Investment LPS assets requirement. Thus, the LLC fund’s investors would not generally be able to qualify for the PE Exemption. Moreover, even if the investors are residents of a country with a tax treaty with Japan, which treaty contains a look-through rule for tax transparent entities, it is unlikely for the fund’s investors to be treated as the FLP in the Investment LPS under the look-through rule. This is because treatment under a tax treaty is generally not used for purposes of interpreting provisions of domestic tax law. Thus, if an investor holds a less

than 25% ownership in the LLC fund, then the investor would probably not be able to meet the less than 25% ownership in the Investment LPS requirement because the less than 25% ownership requirement would still be tested at the LLC fund level (no pass-through treatment).

FIGURE 4: OFFSHORE LLC FUND STRUCTURE



Conclusion.

Whether the PE Exemption and Partnership Attribution Exception increase FDI as intended remains to be seen. It is hoped that additional guidance will be issued to help clarify many of these unresolved issues, especially as they relate to foreign funds, their structures, and the practical issues they face. It is anticipated that additional guidance in the form of commentaries from the Japanese Ministry of Finance will be issued around June 2009.

Links.

2009 Tax Reform draft bill:
<http://www.mof.go.jp/houan/171/houan.htm#sy3>

Japan LPS Act:
http://www.meti.go.jp/policy/sangyou_kinyuu/kumiaiho_u.htm

White & Case in Tokyo

White & Case LLP was one of the first foreign law firms to open in Japan when the law was changed to permit such firms to establish offices in Japan in 1987. It now has more *gaikokuho-jimu bengoshi* (registered foreign lawyers) than any other law firm in Japan as well as one of the largest groups of Japanese attorneys for a foreign-based law firm. White & Case LLP was the first foreign firm to establish a “joint enterprise” with Japanese attorneys and is unique in its success in integrating into the domestic Japanese legal scene by attracting both foreign attorneys with Japanese language ability and Japanese lawyers with international experience as well as establishing teams of Japanese and foreign professionals who are effective in dealing in Japan’s bi-legal, bi-lingual and bi-cultural environment. The Tokyo office of White & Case LLP now boasts over 100 professionals, including not only *gaikokuho-jimu bengoshi* and Japanese attorneys but also licensed tax attorneys (*zeirishi*).

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The Tax Practice Group of White & Case LLP’s Tokyo office is widely recognized as Japan’s leading international tax practice with the ability to effectively resolve the most challenging problems and engage in sophisticated tax planning. Comprised of both US tax lawyers and Japanese tax attorneys (*zeirishi*), the Tokyo Tax Practice Group focuses broadly on transfer pricing, permanent establishment issues and other international tax planning and controversies, the tax aspects of corporate mergers, acquisitions, reorganizations, joint ventures, inbound and outbound syndicated investment structures involving real property, distressed debt and other assets, financial products and global trading, mutual funds and other domestic and cross-border taxation advisory matters. The Tax Practice Group also engages in a rulings and legislative (lobbying) practice.

White & Case provides clients with the most effective tax-related legal advice available. We consistently deliver excellent results for our clients by providing innovative, efficient tax solutions. The breadth and depth of the Tax practice’s success is evidenced by the numerous awards we’ve received from organizations, such as *International Tax Review*, *Chambers & Partners*, *Legal 500*, *Chambers Global* and *Global Counsel*, including:

- Tier One Japan Tax Practice (Foreign Firms)—*Chambers Asia*, 2009
- Tier One for Japan Tax (Foreign Firms)—*Asia Pacific Legal 500*, 2008/2009

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